X. RECENT PROPOSALS TO MODIFY THE TAX TREATMENT OF U.S. CITIZENS AND RESIDENTS WHO RELINQUISH CITIZENSHIP OR TERMINATE RESIDENCY

A. Overview

Several alternatives to the present-law alternative tax regime have been considered. One alternative is a mark-to-market income tax upon an individual's citizenship relinquishment or residency termination. Such an approach would subject such individuals to U.S. income tax on the net unrealized gain with respect to their worldwide assets as if such property were sold for fair market value on the date of citizenship relinquishment or residency termination. Among other things, such an approach would differ from the present-law alternative tax regime in that the mark-to-market tax would be imposed regardless of whether the individual's citizenship relinquishment or residency termination was tax-motivated.

This section describes several recent mark-to-market tax proposals relating to citizenship relinquishment or residency termination: (1) the Clinton Administration's Fiscal Year 2001 Budget Proposal (the "Clinton Budget proposal"); (2) a bill introduced on October 19, 1999, by Representatives Rangel and Matsui (H.R. 3099, 106th Congress), and similar bills introduced on June 26, 2002, by Representatives Rangel and Gephardt (H.R. 4880, 107th Congress) and on July 22, 2002, by Senators Harkin and Stabenow (S. 2769, 107th Congress), (unless otherwise indicated, these bills are referred to collectively as the "House bill"); and (3) a bill passed by the Senate on October 3, 2002, (as an amendment to H.R. 5063) (the "Senate amendment"). This section also discusses general issues presented by a mark-to-market tax on citizenship relinquishment or residency termination.[543]

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[543] For a more detailed discussion of a mark-to-market tax upon citizenship relinquishment or residency termination, see the 1995 Joint Committee staff study, supra note 315. The 1995 Joint Committee staff study analyzed various proposals to modify the tax treatment of citizenship relinquishment and residency termination that would have required U.S. citizens and certain long-term residents to pay a mark-to-market tax with respect to unrealized gains on their assets upon citizenship relinquishment or residency termination. The Clinton Administration submitted such a proposal as part of the President's Fiscal Year 1996 Budget, which was included in H.R. 981 and S. 453 on February 16, 1995. The Congress considered a modified version of the Clinton Administration's Fiscal Year 1996 Budget Proposal, which passed the Senate as an amendment to H.R. 831 on March 25, 1995. The Congress also considered a modified version of that Clinton Administration proposal, which passed the Senate as an amendment to H.R. 3448 on July 9, 1996. For a recent proposal relating to a mark-to-market tax on former citizens and former long-term residents, see the Clinton Administration's Fiscal Year 2001 Budget Proposal described below.

B. Summary of Proposals

In general, each of the mark-to-market proposals would impose a mark-to-market income tax on unrealized gains when an individual relinquishes citizenship or terminates residency, regardless of the taxpayer's subjective motivation for citizenship relinquishment or residency termination. In this regard, individuals who relinquish citizenship and long-term residents who terminate residency would be treated as having sold all their property at fair market value immediately prior to the citizenship relinquishment or residency termination. In general, the deemed sale rule applies to all property interests held by the individual on the date of citizenship relinquishment or residency termination. The proposals would generally exempt the first $600,000 worth of deemed gain. The proposals also provide various exemptions of certain types of property interests from the deemed sale rule (e.g., interests in U.S. real property).

There are variations among the proposals. For example, some proposals would subject all U.S. citizens who renounce citizenship and long-term residents who terminate U.S. residency to the mark-to-market regime, while other proposals would also require the individual's average tax liability or net worth to exceed certain specified levels. In addition, some proposals would replace the existing regime for taxing former citizens and former residents with the mark-to-market regime on a prospective basis, while other proposals would appear to retain both regimes (present law and the mark-to-market regime) without clear coordination rules.

The proposals generally would permit an individual to elect to defer payment of the mark-to-market tax imposed on the deemed sale of property. However, in order to elect deferral of the mark-to-market tax, the individual would be required to provide adequate security to ensure that the deferred tax and interest will be paid. The proposals contain some variations with respect to the manner in which adequate security may be provided.

The proposals would tax U.S. recipients of gifts or bequests made by a former citizen or former long-term resident subject to the mark-to-market rules. The manner of taxing the recipient varies to some degree among the proposals. For example, some proposals would tax the recipient on the full value of the property received as taxable gross income, while other proposals would tax the recipient on the full value of the property based on the applicable transfer tax rates. In addition, some proposals provide exceptions from the tax to the recipient, for example, in cases in which the property is taxable and shown on a timely filed gift or estate tax return of the former citizen or former resident.

Some proposals also contain provisions which coordinate the mark-to-market tax rules with immigration rules that apply to former citizens. For example, some proposals would eliminate the present-law immigration requirement that an individual's citizenship relinquishment be tax-motivated, and instead deny former citizens reentry into the United States unless he or she complies with applicable U.S. Federal tax obligations.

C. Description of Proposals

1. Clinton Budget proposal

In general

The Clinton Budget proposal to modify the tax treatment of U.S. citizens and residents who relinquish their citizenship or terminate their residency was transmitted to the Congress in conceptual form in the President's Fiscal Year 2001 Budget Proposal on February 7, 2000. The Clinton Budget proposal would replace the present-law income tax rules under the alternative tax regime with rules that generally would subject to tax U.S. citizens who relinquish their citizenship and long-term U.S. residents who terminate their residence on the net unrealized gain in their property as if such property were sold for fair market value on the date of citizenship relinquishment or residency termination. The new mark-to-market tax on individuals who relinquish citizenship or terminate residency would apply regardless of the taxpayer's subjective motive for citizenship relinquishment or residency termination. The proposal would provide certain rules and exclusions similar to those provided in the Senate amendment to the Health Insurance Portability and Accountability Act of 1996.

Individuals covered

The proposal would apply the mark-to-market tax to U.S. citizens who renounce citizenship and long-term residents who terminate U.S. residency. For this purpose, a long-term resident is any individual who was a lawful permanent resident of the United States for at least eight out of the 15 taxable years ending with the year in which the residency termination occurs.[544] An individual's U.S. residency is considered to be terminated when either the individual ceases to be a lawful permanent resident[545] (i.e., the individual loses his or her green card status) or the individual is treated as a resident of another country under a tax treaty (and the individual does not elect to waive the benefits of such treaty).

Deemed sale of property upon citizenship relinquishment or residency termination

Under the proposal, individuals who relinquish citizenship and long-term residents who terminate residency generally would be treated as having sold all their property at fair market value immediately prior to the citizenship relinquishment or residency termination. Gain or loss from the deemed sale of property would be recognized at that time, generally without regard to provisions that would otherwise provide nonrecognition treatment. The net gain, if any, on the deemed sale would be subject to U.S. tax at such time to the extent it exceeds $600,000 ($1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency).

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[544] In applying this eight-year test, an individual is not considered to be a lawful permanent resident of the United States for any year in which the individual is taxed as a resident of another country under a treaty tie-breaker rule.

[545] Sec. 7701(b)(6)

The deemed sale rule of the proposal generally would apply to all property interests held by the individual on the date of citizenship relinquishment or residency termination, provided that the gain on such property interest would be includible in the individual's gross income if such property interest were sold for its fair market value on such date. Special rules would apply in the case of trust interests. U.S. real property interests, which remain subject to U.S. taxing jurisdiction in the hands of nonresident noncitizens, generally are excepted from the proposal. An exception also would apply to interests in qualified retirement plans and, subject to a limit of $500,000, interests in certain foreign pension plans as prescribed by regulations. The Secretary of the Treasury would be authorized to except other property interests as appropriate.

Deferral of payment of tax

Under the proposal, an individual would be permitted to elect to defer payment of the mark-to-market tax imposed on the deemed sale of the property. Under this election, the mark-to-market tax attributable to a particular property, plus interest thereon, would be due when the property is subsequently disposed. In order to elect deferral of the mark-to-market tax, the individual would be required to provide adequate security (e.g., a bond) to ensure that the deferred tax and interest will ultimately be paid.

Date of citizenship relinquishment

Under the proposal, an individual is treated as having relinquished U.S. citizenship on the date that the individual first notifies a U.S. consular officer of his or her intention to relinquish U.S. citizenship.

Effect on present-law alternative tax regime

The Clinton Budget proposal would replace the present-law income tax rules under section 877 with the mark-to-market rules described above. In addition, the proposal would repeal the special estate and gift tax rules under the alternative tax regime that currently apply to former citizens and former long-term residents. Thus, the special estate tax rule relating to a former citizen's or former long-term resident's estate including stock in certain foreign corporations would be repealed. In addition, the special gift tax rule for transfers of certain intangibles of former citizens and former long-term residents also would be repealed.

Treatment of gifts and bequests from a former citizen or former long-term resident

If a former citizen or former long-term resident subsequently makes a gift or bequest to a U.S. person, the proposal would treat the gift as taxable gross income to the U.S. recipient, taxable at the highest marginal tax rates applicable to gifts and bequests (and not the marginal income tax rates).

Coordination with immigration rules

The proposal would amend the immigration rules that deny reentry into the United States for individuals who renounce citizenship for tax reasons by removing the requirement that the renunciation of citizenship be tax motivated. In addition, the proposal would coordinate the revised immigration rules with the proposal's tax rules. In this regard, it is understood that the proposal would deny former citizens reentry into the United States (regardless of their subjective motive for renouncing citizenship) if the former citizen did not comply with their tax obligations under the mark-to-market tax proposal. Reentry would be permitted for those individuals who satisfied their tax obligations, if any, under the tax proposal.

Effective date

The proposal would apply to U.S. citizens who relinquish their citizenship and to long-term residents who terminate their residency on or after the date of first committee action.

2. House bill (H.R. 3099, H.R. 4880, and S. 2769)

In general

Representatives Rangel and Matsui introduced H.R. 3099 on October 19, 1999. Similar bills were introduced on June 26, 2002, by Representatives Rangel and Gephardt (H.R. 4880), and on July 22, 2002, by Senators Harkin and Stabenow (S. 2769) (unless otherwise indicated, these bills are collectively referred to as the "House bill"). Like the Clinton Budget proposal, the House bill generally would subject certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who terminate their U.S. residence to tax on the net unrealized gain in their property as if such property were sold for fair market value on the day before the citizenship relinquishment or residency termination. Gain or loss from the deemed sale would be recognized at that time without regard to other Code provisions. Any net gain on the deemed sale would be recognized to the extent it exceeds $600,000 ($1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency).

Individuals covered

The mark-to-market tax would apply to U.S. citizens who relinquish citizenship and long-term residents who terminate U.S. residency and whose average income tax liability or net worth exceed specified levels. The income tax liability threshold is met if the individual's average annual U.S. Federal income tax liability for the five taxable years ending before the date of the citizenship relinquishment or residency termination is greater than $100,000 (indexed for inflation after 1996). The net worth threshold is met if the individual's net worth as of the date of citizenship relinquishment or residency termination is $500,000 or more (indexed for inflation after 1996). These are the same thresholds as in present-law.[546] Thus, the House bill generally would apply only to certain former U.S. citizens or long-term residents meeting the specified thresholds.[547]

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[546] The income tax liability and net worth thresholds under section 877(a)(2) for 2003 are $122,000 and $608,000, respectively. *See* Rev. Proc. 2002-70. 46 I.R.B. 845.

[547] As described above, similar to the House bill, the mark-to-market tax under the Clinton Budget proposal would apply only to net gain on the deemed sale in excess of $600,000

An individual is a long-term resident if he or she was a lawful permanent resident for at least eight out of the 15 taxable years ending with the year in which the residency termination occurs. An individual is considered to terminate long-term residency when either the individual ceases to be a lawful permanent resident (i.e., loses his or her green card status) or the individual is treated as a resident of another country under a tax treaty and the individual does not waive the benefits of the treaty.

Exceptions from the mark-to-market tax are provided in two situations. The first exception applies to an individual who was born with citizenship both in the United States and in another country; provided that (1) as of the citizenship relinquishment date the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual was a resident of the United States for no more than eight out of the 15 taxable years ending with the year of citizenship relinquishment. The second exception applies to a U.S. citizen who relinquishes U.S. citizenship before reaching age 18½ ; provided that the individual was a resident of the United States for no more than five taxable years before such relinquishment.

Deemed sale of property upon citizenship relinquishment or residency termination

The deemed sale rule generally applies to all property interests held by the individual on the date of citizenship relinquishment or residency termination. Special rules would apply in the case of trust interests (described below). U.S. real property interests, which remain subject to U.S. tax in the hands of nonresident noncitizens, generally would be excepted from the mark-to-market tax. An exception also would apply for interests in qualified retirement plans and, subject to a limit of $500,000, interests in certain foreign pension plans as prescribed by regulations.

Deferral of payment of tax

An individual would be permitted to elect to defer payment of the mark-to-market tax imposed on the deemed sale of the property. Under this election, the mark-to-market tax attributable to a particular property is due when the property is disposed (or, if the property is disposed in whole or in part in a nonrecognition transaction, such other time as the Secretary may prescribe). The mark-to-market tax attributable to a particular property is an amount which bears the same ratio to the total mark-to-market tax for the year as the gain taken into account with respect to such property bears to the total gain taken into account under these rules for the year. The deferral of the mark-to-market tax may not be postponed beyond the individual's death.

In order to elect deferral of the mark-to-market tax, the individual would be required to provide adequate security to ensure that the deferred tax and interest will be paid. A bond in the amount of the deferred tax and interest would constitute adequate security. Other security mechanisms would be permitted provided that the individual establishes to the satisfaction of the

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($1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency).

Secretary that the security is adequate. In the event that the security provided with respect to a particular property subsequently becomes inadequate and the individual fails to correct the situation, the deferred tax and the interest with respect to such property will become due. As a further condition to making the election, the individual would be required to consent to the waiver of any treaty rights that would preclude the collection of the tax.

Interests in trusts

Detailed rules would apply to trust interests held by an individual at the time of citizenship relinquishment or residency termination. The treatment of trust interests depends on whether the trust is a qualified trust. A qualified trust is a trust that is organized under and governed by U.S. law and that is required by its instruments to have at least one U.S. trustee.

Nonqualified trusts

If an individual holds an interest in a trust that is not a qualified trust, a special rule applies for purposes of determining the amount of the mark-to-market tax due with respect to such trust interest. The individual's interest in the trust is treated as a separate trust consisting of the trust assets allocable to such interest. Such separate trust is treated as having sold its assets as of the date of citizenship relinquishment or residency termination and having distributed all of the proceeds to the individual, who then is treated as having recontributed the proceeds to the trust. The individual is subject to the mark-to-market tax with respect to any net income or gain arising from the deemed distribution from the trust.

The election to defer payment is available for the mark-to-market tax attributable to a nonqualified trust interest. A beneficiary's interest in a nonqualified trust is determined under all the facts and circumstances, including the trust instrument, letters of wishes, and historical patterns of trust distributions.

Qualified trusts

If an individual has an interest in a qualified trust, the amount of unrealized gain allocable to the individual's trust interest is calculated at the time of citizenship relinquishment or residency termination. In determining this amount, all contingencies and discretionary interests are assumed to be resolved in the individual's favor (i.e., the individual is allocated the maximum amount that he could receive). The mark-to-market tax imposed on such gains would be collected when the individual receives distributions from the trust, or if earlier, upon the individual's death. Interest is charged for the period the tax is deferred.

If an individual has an interest in a qualified trust, the individual is subject to the mark-to-market tax upon the receipt of distributions from the trust. These distributions also may be subject to other U.S. income taxes. If a distribution from a qualified trust is made after the individual relinquishes citizenship or terminates residency, the mark-to-market tax is imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates, but in no event will the tax imposed exceed the deferred tax amount with respect to the trust interest. For this purpose, the deferred tax amount would be equal to (1) the tax calculated with respect to the unrealized gain allocable to the trust interest at the time of citizenship relinquishment or residency termination, (2) increased by interest thereon, and (3) reduced by any mark-to-market tax imposed on prior trust distributions to the individual.

Mark-to-market taxes become due if the trust ceases to be a qualified trust, the individual disposes of his qualified trust interest, or if the individual dies. In such cases, the amount of mark-to-market tax would be equal to the lesser of (1) the tax calculated under the rules for nonqualified trust interests as of such date, or (2) the deferred tax amount with respect to the trust interest as of such date.

The tax that is imposed on distributions from a qualified trust generally is deducted and withheld by the trustees. If the individual does not agree to waive treaty rights that would preclude collection of the tax, the tax with respect to such distributions is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against such individual with respect to the tax. Similar rules apply when the qualified trust interest is disposed, the trust ceases to be a qualified trust, or the individual dies.

Date of citizenship relinquishment

An individual is treated as having relinquished U.S. citizenship on the date that the individual first makes known to the U.S. government or consular officer his intention to relinquish U.S. citizenship. Thus, a U.S. citizen who relinquishes citizenship by formally renouncing his nationality before a diplomatic or consular officer of the United States is treated as having relinquished citizenship on that date; provided that the renunciation is later confirmed by the issuance of a CLN.

A U.S. citizen who furnishes to the Department of State a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act with the requisite interest to relinquish his citizenship is treated as having relinquished his or her citizenship on the date the statement is furnished (regardless of when the expatriating act was performed); provided that the voluntary relinquishment is later confirmed by the issuance of a CLN. If neither of these circumstances exist, the individual is treated as having relinquished citizenship on the date a CLN is issued or a certificate of naturalization is canceled by a court. The date of citizenship relinquishment would apply for all purposes under the bill.

Effect on present-law alternative tax regime

There are no special coordination rules with the present-law alternative tax regime (e.g., section 877). Thus, it is unclear how the bill would interact with the present-law alternative tax regime, and, if they both apply, how potential double taxation would be addressed.

Treatment of gifts and bequests from a former citizen or former long-term resident

Any U.S. citizen or resident who receives a gift or bequest at the time the transferor was a former citizen or former long-term resident is subject to transfer tax on the value of the gift or bequest. Thus, the tax would be imposed on the recipient, but only to the extent that the gift or bequest during the year exceeds the gift tax annual exclusion. The tax would not apply to property that is shown on a timely filed gift tax return and that is a taxable gift by the former citizen or former long-term resident, or property that is shown on a timely filed estate tax return of the former citizen or former long-term resident. Applicable gifts or bequests that are made in trust would be treated as made to the beneficiaries of the trust in proportion to their respective interests in the trust. The tax imposed on any such gifts or bequests would be reduced by the amount of any foreign gift or estate taxes paid with respect to such gifts or bequests.

Coordination with immigration rules

There are no special rules that would coordinate the mark-to-market tax rules with the special immigration rules enacted in 1996 for tax-motivated expatriates.

Effective date

The Rangel-Matsui bill (H.R. 3099) and the Rangel-Gephardt bill (H.R. 4880) generally would be effective for U.S. citizens who relinquish citizenship or long-term residents who terminate their residency on or after the date of action by the House Ways and Means Committee. The Harkin-Stabenow bill (S.2769) generally would be effective for U.S. citizens who relinquish their citizenship or long-term residents who terminate their residency on or after the date of action by the Senate Finance Committee.

The provisions of the Rangel-Matsui bill (H.R. 3099) and the Rangel-Gephardt bill (H.R. 4880) relating to gifts and bequests would be effective for gifts and bequests received from former citizens and former long-term residents on or after the date of action by the House Ways and Means Committee on this bill, regardless of when the transferor relinquished citizenship or terminated residency. The provisions of the Harkin-Stabenow bill (S. 2769) relating to gifts and bequests would be effective for gifts and bequests received from former citizens and former long-term residents on or after the date of action by Senate Finance Committee on this bill, regardless of when the transferor relinquished citizenship or terminated residency.

3. Senate amendment (H.R. 5063)

In general

The Senate passed a bill as an amendment to H.R. 5063 on October 3, 2002 ("the Senate amendment"). Like the Clinton Budget proposal and the House bill, the Senate amendment generally subjects certain U.S. citizens who relinquish their citizenship and certain long-term U.S. residents who terminate their residence to tax on the net unrealized gain in their property as if such property were sold for fair market value on the day before the citizenship relinquishment or residency termination. Gain from the deemed sale is taken into account at that time without regard to other Code provisions; any loss from the deemed sale generally would be taken into account to the extent otherwise provided in the Code. Any net gain on the deemed sale is recognized to the extent it exceeds $600,000 ($1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency). The $600,000 amount is increased by a cost of living adjustment factor for calendar years after 2002.

Individuals covered

The mark-to-market tax applies to U.S. citizens who relinquish citizenship and long-term residents who terminate U.S. residency. An individual is a long-term resident if he or she was a lawful permanent resident for at least 8 out of the 15 taxable years ending with the year in which the residency termination occurs. An individual is considered to terminate long-term residency when either the individual ceases to be a lawful permanent resident (i.e., loses his or her green card status), or the individual is treated as a resident of another country under a tax treaty and the individual does not waive the benefits of the treaty.

Exceptions from the mark-to-market tax are provided in two situations. The first exception applies to an individual who was born with citizenship both in the United States and in another country; provided that (1) as of the citizenship relinquishment date the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual was not a resident of the United States for the 5 taxable years ending with the year of citizenship relinquishment. The second exception applies to a U.S. citizen who relinquishes U.S. citizenship before reaching age 18 ½, provided that the individual was a resident of the United States for no more than 5 taxable years before such relinquishment.

Election to be treated as a U.S. citizen

An individual is permitted to make an irrevocable election to continue to be taxed as a U.S. citizen with respect to all property that otherwise is covered by the expatriation tax. This election is an "all or nothing" election; an individual is not permitted to elect this treatment for some property but not for other property. The election, if made, applies to all property that would be subject to the expatriation tax and to any property the basis of which is determined by reference to such property. Under this election, the individual would continue to pay U.S. income taxes at the rates applicable to U.S. citizens following citizenship relinquishment or residency termination on any income generated by the property and on any gain realized on the disposition of the property. In addition, the property would continue to be subject to U.S. gift, estate, and generation-skipping transfer taxes. In order to make this election, the individual is required to waive any treaty rights that would preclude the collection of the tax.

The individual also would be required to provide security to ensure payment of the tax under this election in such form, manner, and amount as the Secretary of the Treasury requires. The amount of mark-to-market tax that would have been owed but for this election (including any interest, penalties, and certain other items) shall be a lien in favor of the United States on all U.S.-situs property owned by the individual. This lien arises on the citizenship relinquishment or residency termination date and continues until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this provision.[548]

[548] The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this provision.

Date of citizenship relinquishment

An individual is treated as having relinquished U.S. citizenship on the earliest of four possible dates: (1) the date that the individual renounces U.S. nationality before a diplomatic or consular officer of the United States (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (2) the date that the individual furnishes to the Department of State a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act (again, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (3) the date that the Department of State issues a certificate of loss of nationality; or (4) the date that a U.S. court cancels a naturalized citizen's certificate of naturalization.

Deemed sale of property upon citizenship relinquishment or residency termination

The deemed sale rule generally applies to all property interests held by the individual on the date of citizenship relinquishment or residency termination. Special rules apply in the case of trust interests, as described below. U.S. real property interests, which remain subject to U.S. tax in the hands of nonresident noncitizens, generally are excepted from the bill. Regulatory authority is granted to the Secretary of the Treasury to except other types of property from the bill.

An individual who is subject to the mark-to-market tax is required to pay a tentative tax equal to the amount of tax that would be due for a hypothetical short tax year ending on the date the individual relinquished citizenship or terminated residency. Thus, the tentative tax is based on all income, gain, deductions, loss, and credits of the individual for the year through such date, including amounts realized from the deemed sale of property. The tentative tax is due on the 90th day after the date of citizenship relinquishment or residency termination.

Retirement plans and similar arrangements

Subject to certain exceptions, the Senate amendment applies to all property interests held by the individual at the time of citizenship relinquishment or residency termination. Accordingly, such property includes an interest in an employer-sponsored retirement plan or deferred compensation arrangement as well as an interest in an individual retirement account or annuity (i.e., an IRA).[549] However, the provision contains a special rule for an interest in a "qualified retirement plan." For purposes of the provision, a "qualified retirement plan" includes an employer-sponsored qualified plan,[550] a qualified annuity,[551] a tax-sheltered annuity,[552] an

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[549] Application of the provision is not limited to an interest that meets the definition of property under section 83 (relating to property transferred in connection with the performance of services).

[550] Sec. 401(a).

[551] Sec. 403(a).

[552] Sec. 403(b).

eligible deferred compensation plan of a governmental employer, [553] or an IRA. [554] The special retirement plan rule applies also, to the extent provided in regulations, to any foreign plan or similar retirement arrangement or program. An interest in a trust that is part of a qualified retirement plan or other arrangement that is subject to the special retirement plan rule is not subject to the rules for interests in trusts (discussed below).

Under the special rule, an amount equal to the present value of the individual's vested, accrued benefit under a qualified retirement plan is treated as having been received by the individual as a distribution under the plan on the day before the individual's citizenship relinquishment or residency termination. It is not intended that the plan would be deemed to have made a distribution for purposes of the tax-favored status of the plan, such as whether a plan may permit distributions before a participant has severed employment. In the case of any later distribution to the individual from the plan, the amount otherwise includible in the individual's income as a result of the distribution is reduced to reflect the amount previously included in income under the special retirement plan rule. The amount of the reduction applied to a distribution is (1) the excess of the amount included in income under the special retirement plan rule over (2) the total reductions applied to any prior distributions. However, under the provision, the retirement plan, and any person acting on the plan's behalf, will treat any later distribution in the same manner as the distribution would be treated without regard to the special retirement plan rule.

The Department of Treasury would be expected to provide guidance for determining the present value of an individual's vested, accrued benefit under a qualified retirement plan, such as the individual's account balance in the case of a defined contribution plan or an IRA, or present value determined under the qualified joint and survivor annuity rules applicable to a defined benefit plan.[555]

Deferral of payment of tax

An individual is permitted to elect to defer payment of the mark-to-market tax imposed on the deemed sale of the property. Interest is charged for the period the tax is deferred at a rate 2 percentage points higher than the rate normally applicable to individual underpayments. Under this election, the mark-to-market tax attributable to a particular property is due when the property is disposed of (or, if the property is disposed of in whole or in part in a nonrecognition transaction, at such other time as the Secretary of the Treasury may prescribe). The mark-to-market tax attributable to a particular property is an amount which bears the same ratio to the total mark-to-market tax for the year as the gain taken into account with respect to such property bears to the total gain taken into account under these rules for the year. The deferral of the mark-to-market tax may not be extended beyond the individual's death.

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[553] Sec. 457(b).

[554] Sec. 408.

[555] Sec. 417(e).

In order to elect deferral of the mark-to-market tax, the individual is required to provide adequate security to the Secretary of the Treasury to ensure that the deferred tax and interest will be paid. Other security mechanisms are permitted provided that the individual establishes to the satisfaction of the Secretary of the Treasury that the security is adequate. In the event that the security provided with respect to a particular property subsequently becomes inadequate and the individual fails to correct the situation, the deferred tax and the interest with respect to such property will become due. As a further condition to making the election, the individual is required to consent to the waiver of any treaty rights that would preclude the collection of the tax.

The deferred amount (including any interest, penalties, and certain other items) shall be a lien in favor of the United States on all U.S.-situs property owned by the individual. This lien shall arise on the citizenship relinquishment or residency termination date and shall continue until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary of the Treasury is satisfied that no further tax liability may arise by reason of this provision.[556]

Interests in trusts

Detailed rules apply to trust interests held by an individual at the time of citizenship relinquishment or residency termination. The treatment of trust interests depends on whether the trust is a qualified trust. A trust is a qualified trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust.

Constructive ownership rules apply to a trust beneficiary that is a corporation, partnership, trust, or estate. In such cases, the shareholders, partners, or beneficiaries of the entity are deemed to be the direct beneficiaries of the trust for purposes of applying these provisions. In addition, an individual who holds (or who is treated as holding) a trust instrument at the time of citizenship relinquishment or residency termination is required to disclose on his or her tax return the methodology used to determine his or her interest in the trust, and whether such individual knows (or has reason to know) that any other beneficiary of the trust uses a different method.

Nonqualified trusts

If an individual holds an interest in a trust that is not a qualified trust, a special rule applies for purposes of determining the amount of the mark-to-market tax due with respect to such trust interest. The individual's interest in the trust is treated as a separate trust consisting of the trust assets allocable to such interest. Such separate trust is treated as having sold its net assets as of the date of citizenship relinquishment or residency termination and having distributed the assets to the individual, who then is treated as having recontributed the assets to

[556] The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this provision.

the trust. The individual is subject to the mark-to-market tax with respect to any net income or gain arising from the deemed distribution from the trust.

The election to defer payment is available for the mark-to-market tax attributable to a nonqualified trust interest. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. A beneficiary's interest in a nonqualified trust is determined under all the facts and circumstances, including the trust instrument, letters of wishes, and historical patterns of trust distributions.

Qualified trusts

If an individual has an interest in a qualified trust, the amount of unrealized gain allocable to the individual's trust interest is calculated at the time of citizenship relinquishment or residency termination. In determining this amount, all contingencies and discretionary interests are assumed to be resolved in the individual's favor (i.e., the individual is allocated the maximum amount that he or she could receive). The mark-to-market tax imposed on such gains is collected when the individual receives distributions from the trust, or if earlier, upon the individual's death. Interest is charged for the period the tax is deferred at a rate 2 percentage points higher than the rate normally applicable to individual underpayments.

If an individual has an interest in a qualified trust, the individual is subject to the mark-to-market tax upon the receipt of distributions from the trust. These distributions also may be subject to other U.S. income taxes. If a distribution from a qualified trust is made after the individual relinquishes citizenship or terminates residency, the mark-to-market tax is imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates, but in no event will the tax imposed exceed the deferred tax amount with respect to the trust interest. For this purpose, the deferred tax amount is equal to (1) the tax calculated with respect to the unrealized gain allocable to the trust interest at the time of citizenship relinquishment or residency termination, (2) increased by interest thereon, and (3) reduced by any mark-to-market tax imposed on prior trust distributions to the individual.

If any individual's interest in a trust is vested as of the citizenship relinquishment or residency termination date (e.g., if the individual's interest in the trust is non-contingent and non-discretionary), the gain allocable to the individual's trust interest is determined based on the trust assets allocable to his or her trust interest. If the individual's interest in the trust is not vested as of the citizenship relinquishment or residency termination date (e.g., if the individual's trust interest is a contingent or discretionary interest), the gain allocable to his or her trust interest is determined based on all of the trust assets that could be allocable to his or her trust interest, determined by resolving all contingencies and discretionary powers in the individual's favor. In the case in which more than one trust beneficiary is subject to the expatriation tax with respect to trust interests that are not vested, the rules are intended to apply so that the same unrealized gain with respect to assets in the trust is not taxed to both individuals.

Mark-to-market taxes become due if the trust ceases to be a qualified trust, the individual disposes of his or her qualified trust interest, or the individual dies. In such cases, the amount of mark-to-market tax equals the lesser of (1) the tax calculated under the rules for nonqualified trust interests as of the date of the triggering event, or (2) the deferred tax amount with respect to the trust interest as of date.

The tax that is imposed on distributions from a qualified trust generally is deducted and withheld by the trustees. If the individual does not agree to waive treaty rights that would preclude collection of the tax, the tax with respect to such distributions is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against such individual with respect to the tax. Similar rules apply when the qualified trust interest is disposed of, the trust ceases to be a qualified trust, or the individual dies.

Coordination with present-law alternative tax regime

The expatriation income tax rules under section 877, and the expatriation estate and gift tax rules under sections 2107 and 2501(a)(3) (described above), do not apply to a former citizen or former long-term resident whose citizenship relinquishment or residency termination occurs on or after September 12, 2002.

Treatment of gifts and inheritances from a former citizen or former long-term resident

The exclusion from income for the value of property acquired by gift or inheritance[557] does not apply to the value of any property received by gift or inheritance from a former citizen or former long-term resident (i.e., an individual who relinquished U.S. citizenship or terminated U.S. residency), subject to the exceptions described above relating to certain dual citizens and minors. Accordingly, a U.S. taxpayer who receives a gift or inheritance from such an individual is required to include the value of such gift or inheritance in gross income and is subject to U.S. tax on such amount. Having included the value of the property in income, the recipient would then take a basis in the property equal to that value. The tax does not apply to property that is shown on a timely filed gift tax return and that is a taxable gift by the former citizen or former long-term resident, or property that is shown on a timely filed estate tax return and included in the gross U.S. estate of the former citizen or former long-term resident (regardless of whether the tax liability shown on such a return is reduced by credits, deductions, or exclusions available under the estate and gift tax rules). In addition, the tax does not apply to property in cases in which no estate or gift tax return is required to be filed, where no such return would have been required to be filed if the former citizen or former long-term resident had not relinquished citizenship or terminated residency, as the case may be. Applicable gifts or bequests that are made in trust are treated as made to the beneficiaries of the trust in proportion to their respective interests in the trust.

Information reporting

The bill provides that certain information reporting requirements under present law[558] applicable to former citizens and former long-term residents also apply for purposes of the bill.

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[557] Sec. 102.

[558] Sec. 6039G.

Immigration rules

The immigration rules that deny tax-motivated expatriates reentry into the United States would be modified to remove the requirement that the citizenship relinquishment be tax motivated, and instead denies former citizens reentry into the United States if the individual is determined not to be in compliance with his or her tax obligations (regardless of the subjective motive for expatriating). For this purpose, the amendment permits the IRS to disclose certain items of return information of an individual, upon written request of the Attorney General or his delegate, as is necessary for making a determination under section 212(a)(10)(E) of the Immigration and Nationality Act. Specifically, the amendment would permit the IRS to disclose to the agency administering section 212(a)(10)(E) whether such taxpayer is in compliance with section 877A and identify the items of noncompliance. Recordkeeping requirements, safeguards, and civil and criminal penalties for unauthorized disclosure or inspection would apply to return information disclosed under this provision.

Effective date

The Senate amendment generally is effective for U.S. citizens who relinquish their citizenship or long-term residents who terminate their residency on or after September 12, 2002. The provisions of the bill relating to gifts and inheritances are effective for gifts and inheritances received from former citizens and former long-term residents on or after September 12, 2002, whose citizenship relinquishment or residency termination occurs on or after such date. The provisions of the bill relating to former citizens under U.S. immigration laws are effective on or after the date of enactment.

4. AICPA proposals

The American Institute of Certified Public Accountants ("AICPA") submitted comments in March 2002 concerning the 1999 Rangel-Matsui bill (H.R. 3099) and the Clinton Administration Fiscal Year 2001 budget proposal. The comments related to the application of the mark-to-market rules, the rules relating to gifts and bequests from former citizens and former residents, and the application of the special immigration rules to former citizens.

Mark-to-market rules

The AICPA proposed several changes to prior mark-to-market proposals, including:

(1) increasing the dollar threshold for excluding deemed gains of former citizens or former residents from the mark-to-market regime (the dollar threshold in several of the prior bills is $600,000 for 2002), or alternatively, correlating the gain exclusion amount to a benchmark, such as twice the amount of the unified credit under section 2010(c) for estate and gift tax purposes;

(2) providing basis adjustments to fair market value for all assets upon commencement of U.S. tax residency;

(3) identifying other acceptable security arrangements under an election to defer payment of the mark-to-market tax, including letters of credit from a U.S. financial institution or a withholding arrangement with a U.S. brokerage firm;

(4) allowing alternative valuation dates for assets that may decline in value, or allowing a refund for stock that does not generate its anticipated value upon exercise of a stock option;

(5) exempting restricted property (e.g., stock options that have not vested) from the mark-to-market rules, or allowing a refund for property that does not vest (or vests at a lower value than that used for purposes of the mark-to-market tax);

(6) providing an exemption amount for foreign pension plans at twice the unified credit amount under section 2010(c);

(7) excluding assets that remain subject to tax from the mark-to-market rules, such as deferred compensation items such as stock options, non-qualified deferred compensation arrangements, and pension plan assets that are subject to U.S. withholding taxes;

(8) limiting the application of the mark-to-market rules to trust assets over which the beneficiary has control (with the resulting exemption from the rules for certain beneficial interests in U.S. non-grantor trusts);

(9) lengthening the long-term residency requirement to apply to individuals who have held a green card for 15 of the last 20 years (compared to 8 out of the last 15 years as under present law); and

(10) clarifying that the mark-to-market rules would apply only to individuals who relinquish citizenship or terminate residency after the effective date of the legislation.

Treatment of gifts and bequests from former citizens and former residents

The AICPA proposed several changes to prior proposals that would tax recipients of gifts and inheritances from former citizens and former residents subject to the mark-to-market rules, including:

(1) providing a credit against the tax for mark-to-market taxes previously paid by the former citizen or former resident;

(2) limiting application of the recipient tax to gifts and bequests received from former citizens and former residents to which the mark-to-market rules apply (thus, not applying the recipient tax to those individuals who are excluded from or otherwise carved out of the mark-to-market rules);

(3) coordinating the annual exclusion for gifts and bequests to provide for annual inflation adjustments (consistent with section 2503(b)(2));

(4) applying the recipient tax only with respect to gifts and bequests from individuals who expatriate or terminate residency after the date of enactment of the mark-to-market rules.

Finally, the AICPA proposed that if new changes to the immigration rules are enacted (e.g., coordination of those rules with the mark-to-market tax rules), then the original immigration rules should be repealed, and the new immigration rules should apply only prospectively.

D. General Issues Raised by Proposals

Income tax rules

Issues common to present law and proposals

Mark-to-market proposals would impose an income tax on unrealized gains when an individual relinquishes citizenship or terminates residency, regardless of the taxpayer's subjective motivation for citizenship relinquishment or residency termination. The mark-to-market proposals thus would eliminate the necessity to examine the former citizen's or former long-term resident's subjective intent in order for the deemed sale rules to apply. The taxation of unrealized gains under the mark-to-market proposals, however, is a departure from the normative U.S. income tax system, which generally imposes tax only on realized gains.

The mark-to-market proposals have been justified on certain grounds. First, some argue that it is appropriate to collect U.S. tax with respect to those individuals who have enjoyed the benefits of U.S. citizenship or residency or with respect to U.S. citizens and long-term residents whose assets have enjoyed the protection of being within U.S. borders.[559] That is, income taxes are one of the costs of citizenship, one of the mechanisms by which the Federal Government finances the benefits that U.S. citizens and long-term residents receive. Under this view, it may be unfair to tax a U.S. citizen who has had no meaningful contacts with the United States and who arguably has not exercised the benefits of citizenship. For example, this rationale would not seem to support imposition of a mark-to-market tax on a U.S. citizen who was born outside the United States and who never lived in nor held assets in the United States. In addition, it may be unfair to tax assets of long-term U.S. residents that were acquired outside the United States and were never brought into the United States. The mark-to-market proposals, however, would impose tax on former citizens and former long-term residents regardless of the level of the individual's U.S. benefits, regardless of any taxes the individual previously has paid, and regardless of the fact that the assets had no relationship with the United States. On the other hand, the individual's worldwide assets, including those assets that have no relationship with the United States, would remain subject to U.S. tax if the individual remains a U.S. citizen or long-term U.S. resident.

Second, some argue that it is appropriate to collect U.S. tax from certain U.S. citizens who relinquish U.S. citizenship but maintain a significant continuing relationship with the United States, including spending significant periods of time in the United States. It is argued that such individuals are not really relinquishing their ties to the United States and, thus, should continue to be taxed as U.S. citizens or residents. Under this view, the tax imposed under the mark-to-market proposals is a proxy for the tax that would have been owed had the individual continued to be a U.S. citizen or resident. If a mark-to-market tax were justified on the basis that the

[559] Some assert that benefits of U.S. citizenship include being able to travel on a U.S. passport and to enjoy the protection of a U.S. embassy outside the United States. Others assert that the benefits of U.S. citizenship relate primarily to beneficial services (such as advances in health care, technology, and modern public works) that are enjoyed by those living in the United States.

individual did not really sever ties with the United States, then it may not be appropriate to impose tax on individuals who clearly maintain no ongoing ties. For example, it may be inappropriate to tax an individual who acquired U.S. citizenship by birth and who has never lived in the United States. The mark-to-market proposals could affect former citizens who have lived abroad their entire lives and who have very tenuous ties to the United States. The mark-to-market proposals also would affect former citizens and former long-term residents who sever all ties with the United States. The proposals addresses this concern to some degree, although they do not completely eliminate the concerns.[560]

Third, proponents of the mark-to-market proposals argue that such proposals would simplify the taxation of former citizens and former long-term residents by eliminating the subjective inquiry into the intent of the former citizen or former long-term resident. Because there is no intent requirement under these proposals, the IRS would not have to delve into specific factual details for each individual's citizenship relinquishment or residency termination to determine if the individual had a tax avoidance motive. Instead, in order to assess the mark-to-market tax, the IRS would simply be required to show that an individual relinquished citizenship or terminated residency. Removing the intent requirement might also lead to increased voluntary compliance, because individuals would no longer be able to rationalize that they are not subject to the tax because they had other reasons for relinquishing citizenship or terminating residency.

These first three issues with respect to the mark-to-market proposals (i.e., collecting tax with respect to those who have enjoyed the benefits of citizenship, collecting tax from those who have not meaningfully severed ties with the United States, and eliminating inquiries into subjective intent) are not unique to the mark-to-market proposals, but rather are common issues with respect to the scope of any tax regime applicable to former citizens and former long-term residents. In fact, these same issues relate to the effectiveness of the present-law alternative tax regime. Some of the recommendations made by the Joint Committee staff with respect to present law address these issues and could also be applicable with respect to the mark-to-market proposals. The arguments discussed below, on the other hand, are more specific to the mark-to-market proposals.

Issues specific to mark-to-market proposals

Some argue that it is appropriate to tax unrealized gains that accrue during the period that an individual was subject to U.S. taxation on a worldwide basis. Under this view, a former citizen or former long-term resident with foreign income or assets should not be permitted to avoid U.S. tax on such income or assets that economically accrued while the individual was a

[560] For example, the House bill provides for an exception to the mark-to-market tax for individuals born with citizenship both in the United States and in another country; provided that, among other things, the individual was a resident of the United States for no more than eight out of the 15 taxable years ending with the year of citizenship relinquishment. The Senate amendment would exclude a dual citizen from birth from the mark-to-market rules if the individual was not a resident of the United States for the five years prior to citizenship relinquishment.

U.S. citizen or U.S. resident. A fundamental general principle of the U.S. Federal income tax system is that it taxes only realized gains. In part, this rule can be viewed as one of administrative convenience: the realization principle addresses liquidity concerns and income measurement valuation problems and costs. Nonetheless, income and gain accrue over time. As a result, the United States arguably has the right to tax the income or gain that accrues while an asset is held by a person who is a U.S. citizen or long-term resident subject to U.S. taxing jurisdiction. In this regard, citizenship relinquishment or residency termination could be viewed as a deemed realization event.[561] Consistent with this rationale, some would argue that an exit tax based on a mark-to-market regime would be more appropriately considered in the context of a broader policy initiative that would mark to market both items that are entering as well as items that are exiting the U.S. taxing jurisdiction.[562] Under such a regime, emphasis would be on measuring and taxing gains and income that accrue while (and only while) a person is a citizen or resident of the United States.

Proponents of the mark-to-market proposals argue that a special tax is more appropriately collected at the time of citizenship relinquishment or residency termination, as compared to collection of a tax over a 10-year period following an individual's citizenship relinquishment or residency termination (as under present law), when the individual may be outside the United States and collection of such taxes may be more difficult. To the extent that an individual does not intend to return to the United States, however, the IRS would likely have many of the same enforcement problems that exist under present law with respect to monitoring and investigating individuals who have physically departed the United States, and identifying individuals subject to the rules.[563] This problem of administration, however, generally is limited to the time of

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[561] Certain provisions under present law depart from the realization requirement, including the mark-to-market regime for securities dealers under section 475, the mark-to-market taxation of certain regulated futures contracts, foreign currency contracts, nonequity options, and dealer equity options under section 1256, and the rules for taxing original issue discount under sections 1271-1275.

[562] For related proposals in this regard, see the Clinton Administration's Fiscal Year 2001 Budget Proposals regarding modifying the treatment of built-in losses and other attribute trafficking and simplifying the taxation of property that no longer produces income effectively connected with a U.S. trade or business.

[563] The mark-to-market proposals also present serious administrability concerns with respect to their application to green-card holders. Unlike the procedures for relinquishing citizenship, there are no formal procedures when a noncitizen terminates U.S. residency by which such an individual is required to relinquish a green card, nor is there any incentive for an individual to actually turn in a green card upon leaving the United States. If such individuals were made aware that a special tax would be imposed upon the relinquishment of a green card, it may be even more likely that these individuals would simply leave the United States without ever notifying the authorities of their departure. Thus, it may be difficult for the IRS to determine the identity of long-term residents who terminate their residency absent any voluntary compliance by these individuals. An additional difficulty arises in the context of green-card holders in that some individuals who would otherwise obtain green-cards could instead obtain

citizenship relinquishment or residency termination. The proposals would ease the overall administrative burdens by not requiring monitoring of transactions over a 10-year period as under present law.[564]

Enforcement issues

Enforcement of the mark-to-market proposals would depend (as under present law) upon the extent to which former citizens and former long-term residents supply the necessary information for the IRS to determine that the requirements for imposing the tax apply. To the extent that the necessary information is not supplied by former citizens, former long-term residents, or appropriate agencies involved in the citizenship relinquishment or residency termination process (as has been the case under present law), enforcement of the tax may not be successful. Under both present law and the mark-to-market proposals, the IRS may not learn about the citizenship relinquishment or residency termination until the individual has physically left the country. In addition, physical separation from the United States may hinder the ability of the IRS to collect any tax owed (as under present law). With notification, the IRS can attempt to determine whether a former citizen or former long-term resident possesses any assets within the United States that could be seized to satisfy the tax liability. Seizure of assets for failure to pay taxes is permitted under present law.[565] The Senate amendment would grant the IRS the authority to impose a lien on U.S.-situs property for taxes that are deferred under that proposal. In addition, the Clinton Budget proposal and the Senate amendment would seek to encourage enforcement of the mark-to-market tax by denying former citizens reentry into the United States (regardless of their subjective motive for expatriating) if the former citizen did not comply with their tax obligations under the proposal.

The mark-to-market proposals would reduce a taxpayer's ability to avoid taxation through tax planning, because a more comprehensive tax base would be utilized. Thus, it would be more difficult to structure one's holdings in a manner designed to avoid the mark-to-market tax.

Critics of the mark-to-market proposals argue that the proposals present enforceability issues that do not exist under present law. Because such proposals would impose a tax on unrealized gains (and, thus, market price for the assets may not be readily available), there may be significant valuation disputes between taxpayers and the IRS. These valuation disputes are likely to be even more problematic in the case of interests in trusts, because beneficiaries who relinquish citizenship or terminate residency would be subject to a tax liability determined by

certain types of nonimmigrant visas if the proposal was enacted and, thus, escape taxation under the proposal. Similar difficulties may exist, however, with respect to the administration of present law in connection with green-card holders.

[564] The strength of the proposals in easing administrative burdens is lessened to some extent by permitting the tax to be paid over a 10-year period. The requirement of posting a bond is helpful in this regard.

[565] Sec. 6331.

reference to the unrealized appreciation in the value of the trust's assets notwithstanding the fact that the beneficiary has no access to the assets of the trust.[566] The proposals also raise liquidity issues because the assets held at the time of citizenship relinquishment or residency termination may not be liquid and, thus, the individual may not have sufficient resources with which to pay the tax upon citizenship relinquishment or residency termination. These liquidity concerns are alleviated to some degree by the ability to defer payment of the mark-to-market tax if certain conditions are met (albeit, as described above, at the cost of lessening the ability to ease administrative burdens).

The mark-to-market proposals may create an incentive to relinquish citizenship or terminate residency that does not exist under present law for individuals who either have recently inherited wealth or who expect to inherit wealth in the near future, because the basis of inherited assets is stepped up to fair market value on the date of the decedent's death. Thus, there would be little or no mark-to-market tax imposed on such assets.

Double taxation issues

The proposals could give rise to potential double taxation issues. For U.S. tax purposes, the proposals would provide for a step up in basis for any gain recognized upon the deemed sale of assets upon citizenship relinquishment or residency termination, so that double taxation of that same gain generally would not occur for U.S. income tax purposes. However, as described below, such a regime could lead to double taxation if a former citizen or former long-term resident is subject to U.S. gift or estate tax on the same property. In addition, double taxation could occur if the foreign country to which the former citizen or former long-term resident became a resident also taxed the same gain upon a later disposition of the asset.[567] In this regard, many countries do not exempt from local tax gains that accrued prior to the time an individual became a resident of that country.[568] Consequently, double taxation will occur if a former citizen or former long-term resident is subject to the mark-to-market tax on the deemed sale of an asset, becomes a resident of another country that includes pre-immigration gains in its tax base, and subsequently sells that asset.[569] In addition, the House bill does not have special coordination

[566] For a discussion of valuation and other problems associated with marking to market interests in trusts under prior mark-to-market proposals, see the 1995 Joint Committee staff study, supra note 315.

[567] Furthermore, the jurisdiction in which the asset is located may also levy its tax on the gain realized.

[568] See Part IX., above. Australia, Canada, Denmark, and Israel are exceptions to the general rule of most countries that tax gains that have accrued prior to the individual's immigration to such country.

[569] Such an individual generally would not be eligible for specific relief from double taxation under a tax treaty. It is uncertain whether double taxation relief could be obtained under a mutual agreement procedure article of an income tax treaty. These articles of U.S. tax treaties generally grant the competent authorities of the treaty countries to consult and resolve double taxation issues regardless of whether they are specifically covered by the treaty. A potential

rules with the present-law alternative tax regime. Thus, it is unclear how the House bill would interact with the present-law alternative tax regime, and, if they both apply, how potential double taxation would be addressed.

International law issues

Some have argued that under certain circumstances a mark-to-market tax upon citizenship relinquishment or residency termination might conflict with rights to emigrate or expatriate recognized by U.S. and international law.[570] In addition, potential constitutional issues have been raised with respect to such a tax.[571] The Joint Committee staff requested the CRS to review the constitutionality of the Clinton Budget proposal and the Rangel-Matsui bill (H.R. 3099), and whether these proposals comport with international law. As a general matter, according to the CRS, the possible application of a mark-to-market regime to those retroactively

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determination is made on a case-by-case basis that is based on the particular facts and circumstances. A former citizen generally would request competent authority assistance from the competent authority of his or her country of residence. The competent authorities may not reach agreement or even if agreement could be reached, the process can be time consuming (and, thus, costly) for the taxpayer. If the gain is attributable to U.S. sources, the foreign country may give a credit against its local tax for the U.S. tax paid.

[570] For a discussion of these issues, see the 1995 Joint Committee staff study, supra note 315. The 1995 Joint Committee staff study pointed out that some observers have labeled prior mark-to-market proposals as "exit taxes" that may conflict with rights to emigrate or expatriate recognized under international law. The 1995 Joint Committee staff study stated that it is difficult to conclude that such proposals would be an arbitrary infringement under international law if the mark-to-market proposals are viewed as an attempt to neutralize the tax consequences that flow under U.S. tax laws from the decision to retain or renounce U.S. citizenship.

[571] *Id.* The 1995 Joint Committee staff study described certain potential constitutional issues raised by prior mark-to-market proposals, such as whether the proposals violate the Constitution on the ground that the Sixteenth Amendment contains an implicit requirement that gains be realized before Federal income taxes are imposed, and whether other aspects of such proposals conflict with constitutional principles such as the due process clause of the Fifth Amendment. The 1995 Joint Committee staff study noted that judicial decisions and legal commentary represent a substantial line of authority for the position that the concept of realization is not constitutionally mandated, and that prior mark-to-market tax proposals generally would not appear to lead to a colorable constitutional challenge under the due process clause of the Fifth Amendment. However, it was also pointed out that there may be due process challenges as applied to particular factual settings, such as the case in which a beneficiary of a trust who has merely a contingent interest in the trust is deemed to have income under a mark-to-market proposal. The study also describes other potential due process challenges that may arise under such proposals, such as the retroactive application of mark-to-market taxes on individuals who have long since relinquished their citizenship under law in effect prior to the enactment of such a regime.

continued as U.S. citizens is an issue that is vulnerable to constitutional challenge.[572] In addressing these issues, the CRS stated the following:

> [W]e believe that the [Clinton] Administration proposal calls for replacing existing IRC § 877 with an exit tax effective for all those relinquishing citizenship on or after the date of first committee action. Generally, limited retroactivity for the period of time it takes to get legislation through the legislative process does not raise due process concerns. In some expatriates' cases, this trade off between 10 years of additional U.S. tax liability and a one-time exit tax may result in lower costs. For others, the opposite would be true. Existing law does not tax those who are not expatriating for tax avoidance purposes, while the [Clinton] Administration proposal would tax everyone expatriating who possesses over $600,000 in assets. The expatriates lacking a tax avoidance purpose have a stronger expectation of no change in the law than do those potentially subject to current IRC § 877. In addition, those who think they lost citizenship years ago and are not expatriating for tax avoidance purposes may be less likely to be well advised (and therefore be on notice of possible tax law changes).[573] Careful consideration should be given to whether it is fair to impose such a tax retroactively on the non-avoiders.
>
> We believe that the exit tax in the House proposal is supposed to be on top of the tax in IRC § 877. If this is correct, the House proposal would impose a new exit tax on everyone expatriating while continuing the existing regime for those who expatriate with tax avoidance purposes. The same objections that might be raised against the [Clinton] Administration proposal might be raised against the House proposal as well. In addition, the arguments that the House exit tax is a new tax, and the arguments that it is not fair to impose a new tax retroactively, seem stronger. This is not to say that imposing such a tax retroactively for a limited period would necessarily be found unconstitutional, but it raises more questions about the fairness of retroactive imposition than does the [Clinton] Administration proposal.[574]

With respect to international law considerations, the CRS stated that a non-confiscatory exit tax would not raise insurmountable international law concerns. However, the CRS concluded that to the extent that the mark-to-market tax is in addition to the present-law alternative tax regime (which may be the case with the House bill), the U.S. assertion of taxing jurisdiction will be seen as that much more outside international norms.[575]

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[572] *See* A-63 (May 10, 2000, memorandum II from the CRS).

[573] On the other hand, they can remain outside the tax system by never appearing before a government official to obtain a CLN.

[574] *See* A-63 (May 10, 2000, memorandum II from the CRS).

[575] *Id.*

Estate and gift tax rules

Under the mark-to-market proposals, the present-law estate and gift tax rules that apply generally to nonresident noncitizens would continue to apply. These individuals would continue to be subject to estate and gift tax on the transfer of U.S.-situated property. However, the Clinton Budget proposal and the Senate amendment would repeal the special estate and gift tax rules that apply to U.S. citizens and long-term residents who give up their U.S. citizenship or resident status with a principal purpose of avoiding U.S. tax.

In addition to imposing a mark-to-market tax upon citizenship relinquishment or residency termination, the mark-to-market proposals would impose a second "inheritance type" tax on the property of a former citizen or former long-term resident that is transferred back to a U.S. person. While the proposals are similar, there are differences in scope and application. Under the Clinton Budget proposal and the Senate amendment, the second tax would be imposed on the receipt of property by a U.S. person from a former U.S. citizen or former long-term resident. Under the Clinton Budget proposal, if a former citizen or former long-term resident subsequently makes a gift or bequest to a U.S. person, the value of the property would be treated as "gross income" to the U.S. recipient, taxable at the highest marginal rate applicable to estates and gifts. Under the Senate amendment, the U.S. recipient of the property would include in gross income the value of the property received from the former citizen or former long-term resident (subject to certain exceptions and with no special provision for taxing the recipient at the highest marginal transfer tax rates).

Under the House bill, the second tax would be imposed on the receipt of property by a U.S. person from any former U.S. citizen or former long-term resident that was subject to the mark-to-market regime upon citizenship relinquishment or residency termination. Under the proposal, if a former citizen or former long-term resident subsequently makes a gift or bequest to a U.S. person, the property would be subject to a new inheritance tax regime. Under this regime, the property received by a U.S. person would be subject to tax at the highest marginal rate applicable to estates and gifts.

Under the mark-to-market proposals, property could be taxed twice – once, based on gain upon citizenship relinquishment or residency termination, and again, based on value upon receipt by a U.S. person. Under present law, property also may be taxed multiple times. For example, property sold at a gain may be subject to income tax at one point and, subsequently, may be subject to estate or gift tax on its entire value. However, applying a similar regime to former U.S. citizens and former long-term residents would be a departure from the present-law alternative tax regime. In some instances, property that is subject to both income and estate and gift tax could be taxed at combined rates significantly higher under the mark-to-market proposals than under present law.

Enforcement of the present-law estate and gift tax rules for former citizens and former long-term residents during a 10-year period presents difficulties. However, the mark-to-market proposals, which would assess an estate and gift tax any time property flows back to a U.S. person from a former citizen or former long-term resident, would present enforcement problems of their own. For example, the new inheritance-type estate and gift tax would apply to property that flows back to a U.S. person at any time after citizenship relinquishment or residency termination. Moreover, it may be difficult to track whether a former U.S. citizen or former long-term resident made a gift or bequest of property for the benefit of a U.S. person.

Immigration rules

The Clinton Budget proposal and the Senate amendment would make certain modifications to the immigration rules with respect to former citizens.[576] The proposals would eliminate the present-law requirement that the individual's citizenship relinquishment be tax-motivated before denying the former citizen reentry into the United States. The proposals also would coordinate the modified immigration provision with the new mark-to-market income tax rules described above and would deny former citizens reentry into the United States if they did not comply with their tax obligations under the mark-to-market regime.

Some argue that this type of coordination between the immigration and tax rules would enhance enforcement and collection of the mark-to-market tax. They argue that the ability of former citizens to reenter the United States should be conditioned on satisfaction of their obligations (including tax obligations) upon leaving the United States. On the other hand, the original purpose of the present-law immigration provision was to prevent tax-motivated former citizens from reentering the United States. Thus, some may question the appropriateness of applying such a provision across the board for all former citizens regardless of motive.

[576] These proposed modifications are not contained in the House bill.